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In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-332

FIRST CALIFORNIA COMPANY, A CORPORATION, LEONARD A. TALBOT, AND MRS. NED F. MANN,
Petitioners,

vs.

HERBERT NEWMAN,
Respondent.

Petition for a Writ of Certiorari To The Court Of Appeal Of The State Of California First Appellate District Division Three

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The Petitioners, First California Company, Leonard A. Talbot and Mrs. Ned F. Mann, respectfully pray that a writ of certiorari be issued to review the judgment and opinion of the California Court of Appeal entered in this proceeding on April 10, 1975.

OPINION BELOW

The published opinion of the California Court of Appeal, 47 Cal.App.3d 60, and the denial of the petition for hearing by the California Supreme Court appear in the Appendix hereto. No opinion was rendered by the Superior Court for

the County of San Francisco, or by the California Supreme Court.

STATUTORY PROVISIONS INVOLVED

Interpretation of the Board of Governors of the National Association of Securities Dealers, CCH NASD Securities Dealers Manual ¶ 2154:

> "In accordance with Article VII, Section 3(a) of the By-laws, the following interpretation under Article III, Sections 1 and 4 of the Rules of Fair Practice has been adopted by the Board:
>
> It shall be deemed conduct inconsistent with just and equitable principles of trade for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security or to charge a commission which is not reasonable."

15 U.S.C. §§ 78b, 78f, and 78o-3 and National Association of Securities Dealers Rules of Fair Practice, Article II, Section 1(j) and Article III, Section 1 and Section 4, are set out in full in the Appendix.

QUESTIONS PRESENTED

A. Do Sections 1 and 4 of the Rules of Fair Practice of the National Association of Securities Dealers as interpreted by the Board of Governors of that Association, prohibit a member broker in an over-the-counter transaction in an infrequently traded stock from completing the transaction until he has determined that the price to be paid for the security is reasonably related to the security's current market price?

B. If the rules do impose a duty to make such a determination, does performance of the duty constitute a defense to an action for refusal to complete a transaction where the broker finds that the price offered is not a fair price?

JURISDICTION

The judgment of the California Court of Appeal was entered on April 10, 1975. A petition for rehearing was denied on May 9, 1975. A timely petition for hearing was denied by the California Supreme Court on June 4, 1975, and this petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1257(3).

Petitioners timely raised the contention that, under Securities Exchange Act 15 U.S.C. 78o-3), the National Association of Securities Dealers ("NASD") Rules and the Interpretation of these Rules by the NASD Board of Governors is binding upon the Respondent as a customer of an NASD member trading on the over-the-counter market and constitutes a defense to this action. The decision below specifically considers and rejects the federal law. The decision of the California Court of Appeal holds that state law, not federal law and NASD Rules and Interpretations promulgated thereunder, applies to this case, and is in direct conflict with the federal law and with the decisions of the federal courts. The decision below is also contradictory to this Court's teachings in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 38 L.Ed.2d 348, 94 S.Ct. 383 (1973).

STATEMENT OF THE CASE

Nature of the Case

This case involves a dispute over whether a National Association of Securities Dealers ("NASD") member broker breached a duty to a potential purchaser for refusing to consummate a sale, where the reason for refusal was compliance with NASD rules. Petitioners, from the initial stages of this action, have asserted that federal securities law and the Rules and Interpretations of the

NASD consituted a defense in this case. Both the trial court and the state appellate court rejected this assertion and applied only California law to the case.

Parties

Mr. and Mrs. Ned F. Mann, a retired couple, owned certain shares of stock of Modesto Savings & Loan and of Modesto Savings & Loan Holding Company (the "Stock").[1] Petitioners Leonard A. Talbot, an employee of Petitioner First California Company, was the broker who contacted both Respondent Herbert Newman and the Manns in regard to the attempt to purchase and sell the stock here in question.

Petitioner Talbot worked in First California Company's Santa Rosa, California office. First California's main office in San Francisco, California, was where all buy and sell orders taken by its salesmen were sent for confirmation and was where all transactions were either completed or rejected.

Offer to Sell

Respondent Newman was contacted by Petitioner Talbot early in 1969 in regard to purchasing certain shares of stock from Mr. and Mrs. Mann. The Manns, also contacted by Mr. Talbot, offered to sell the Stock through Talbot and First California Company, conditioned upon all their shares of both the Savings & Loan and the Holding Company being sold.

The Stock was to be sold on the over-the-counter market; however, so far as has been discovered, only two transactions had taken place in the Modesto Savings & Loan and the Holding Company stock in the four months previous

1. Ned F. Mann died before this action was commenced and Mrs. Ned F. Mann is a petitioner herein.

to this attempted transaction.[2] Since there was not an active market in the securities, Mr. Talbot agreed to locate buyers for the Stock. Correspondingly, since there was no established market price for the Stock, a fair and equitable price had to be determined.

Offers to Purchase

By the afternoon of February 17, 1969, First California Company had obtained purchase orders for all of the Stock. Among these orders was Mr. Newman's order to purchase. Mr. Talbot and First California Company represented both the Manns and Mr. Newman in the proposed transaction.

Merger

On February 17, 1969, First California Company began determining whether the price offered compared favorably to the fair market price for the Stock by investigating the worth of the Savings & Loan and the Holding Company as investments. On February 20, 1969, while First California's investigation was still uncompleted, the merger of Modesto Savings & Loan into Golden West Financial Corporation was announced. The merger of the Savings & Loan into Golden West so drastically increased the value for the Stock that the offered price could not be considered reasonably related to the current market price. Therefore, the sale was not consummated.

The Lawsuit

On February 21, 1969, Talbot informed Newman of the merger and that the transaction with the Manns would not be completed. Newman has never paid any part of the purchase price for the Stock, and there is no evidence that any

2. One of these two sales was to Petitioner Talbot.

bookkeeping entry reflecting payment has been recorded or that the Stock has ever been transferred into the account of or delivered to Newman.

Newman filed the action below in the Superior Court in and for the City and County of San Francisco, State of California on January 29, 1971. The action was in contract and negligence and was based upon the theory that a contract of sale under California law had been made.

Both the Superior Court and the Court of Appeal rejected Petitioners' contentions that the federal securities laws and the NASD Rules and Interpretations promulgated thereunder constituted a possible defense of this case and refused to instruct the jury as to the NASD Rules upon which defendant predicated its defense. The Superior Court allowed no evidence on this theory to be submitted. The case was decided solely, therefore, on California Law.[3]

REASONS FOR GRANTING THE WRIT

I. The Decision Below Involves a Substantial Federal Question Which Has Not Been Settled by This Court.

The decision below holds that the NASD Rules do not have the same status as the rules of a national securities exchange, and that in any event, the NASD Rules do not require a broker's independent investigation of the fairness of the price of a rarely traded stock even where the broker represents both the buyer and the seller. These holdings are incorrect, conflict with decisions of the United States Court of Appeals and District Courts, deprive investors on the

3. Pages 133-143 of the Reporter's Transcript reproduced in the Appendix show Petitioners' attempt to introduce evidence at trial relevant to the defense afforded by the federal securities law through the NASD Rules. Pages 25, 27, 28, 31 and 33 of the Clerk's Transcript are reproduced in the Appendix showing some of the jury instructions, on the federal law, requested by Petitioners which were rejected by the trial court.

over-the-counter market of the protections intended by the Securities Exchange Act of 1934 (the "Act") (15 U.S.C. 78(a), et seq.), and are contrary to the teachings of *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware,* 414 U.S. 117, 38 L.Ed.2d 348, 94 S.Ct. 383 (1973).

The Act was adopted to protect investors by regulating transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets. (15 U.S.C. § 78b; *Thill Securities Corp. v. New York Stock Exchange,* 433 F.2d 264 (7th Cir., 1970).) The Securities and Exchange Commission (the "Commission") was created and given the power to regulate and control national securities exchanges and national securities associations. (15 U.S.C. 78f and 78o-3.) The self-regulatory, rule making and control functions which are required of a national securities exchange (15 U.S.C. 78f) are substantially similar to those required of a national association of securities dealers (15 U.S.C. 78o-3).

Before an association may be registered, it must satisfy the Commission that it has met a number of standards set out in the Act. (See, generally, 15 U.S.C. § 78o-3(b).) Thus, the association must have rules "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market . . .". (15 U.S.C. § 78o-3(b)(8).)

The rules of the association must provide: "that its members and persons associated with its members shall be appropriately disciplined by expulsion, suspension, fine, censure or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules." (15 U.S.C. § 78o-3(b)(9).)

The NASD is the only such association registered with the Commission. Most, if not practically all, of the securities brokers in the United States are members of the NASD. (Loss, *Securities Regulation,* 2d Ed. 1961, Vol. II, pp. 1365.) The NASD was created in order to establish "a mechanism of regulation among the over-the-counter brokers and dealers . . . to prevent acts and practices inconsistent with just and equitable principles of trade." (*Harwell v. Growth Programs, Inc.,* 315 F.Supp. 1184, 1188 (D.C.Tex., 1970); reversed on other grounds, 451 F.2d 240.)

As stated in *Harwell, supra,* 315 F.Supp. at 1188:

> "Far from being just an ordinary corporation, the National Association of Securities Dealers, although organized as a Delaware non-profit corporation, is the 'only national securities association' registered under the Maloney Act; it is thus effectively a congressionally created regulatory organization governing conduct in the over-the-counter securities market."

Petitioners brought to the attention of the trial court and the Court of Appeal, an interpretation by the NASD Board of Governors of Rules of Fair Practice 1 and 4 as follows:

> "It shall be deemed conduct inconsistent with just and equitable principles of trade for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security or to charge a commission which is not reasonable."
>
> CCH NASD Securities Dealers Manual ¶ 2154, p. 2056.

Referring to this Interpretation, the Superior Court below stated, "That doesn't mean a thing, for this reason: All that says, number one, is what the Commission doesn't like, but that has nothing to do with whether a transaction

has been entered into." (Reporter's Transcript 140:3, reproduced in the Appendix.)

However, this Interpretation directly states that the securities price of a transaction with an NASD member must be reasonably related to the *current market price.* Only by investigating can that price be determined. Accordingly, the broker had a duty to investigate and the lower court's conclusion to the contrary is in error.

Additionally, the decision below, in applying California law to the case, ignored the NASD Rules of Fair Practice, Article II, Section 1(j) defining "The completion of the transaction." This section, set out in full in the Appendix, provides *inter alia* that the transaction is completed as to a purchaser: (1) when the customer pays the NASD member any part of the purchase price or when the member effects payment by a bookkeeping entry; or (2) if payment is made before requested, then when the security is delivered to or into the account of such customer.

In this case none of the necessary events occurred to cause the transaction to be completed. The decision below constitutes binding precedent in the California State Courts and severely impedes the application of Article II, Section 1(j) of the NASD Rules.

The decision below places all NASD members doing business in California in the middle of a conflict between state and federal law. First, state law requires the broker to complete a stock transaction as soon as he matches a buy order with a sell order, yet the NASD Board of Governors has published an Interpretation[4] requiring the member broker to determine that the price of the security is reasonably related to its current market price. Second, state law now says that a transaction is complete once buy and sell orders are

4. CCH NASD Securities Dealers Manual ¶ 2154.

matched, yet the NASD Rules impose further requirements before the transaction is completed. As a result of this decision, NASD members will, in many situations, not be able to comply with both the state and the federal law.

If the courts below had found that First California Company had the duty to determine the fairness of the Stock's price before completing the transaction, the federal law, as applied in *Financial House v. Otten,* 369 F.Supp. 105 (D.C. Mich., 1973), and *Bache & Co. v. Clay,* 366 F.Supp. 1248, 1251 (D.C.Okla., 1973), would have incorporated this duty into the contracts which First California Company had with both Newman and the Manns. Petitioners would then have been able to introduce evidence that First California Company, in performing this duty, found the proposed price of the stock to be unfair. Also, the jury would have been instructed to find that there was no contract and no breach if they found that the proposed price of the stock did not reasonably relate to the market price of the stock at the time that the transaction was rejected by First California Company.

The decision below has incorrectly decided a question of federal securities law thereby impeding the development and frustrating the administration of the vast over-the-counter market.

This important question of federal securities law justifies the grant of certiorari to review the decision below.

II. The Decision Below Conflicts with the Decision of the Federal Courts as to the Impact of the Rules of the National Association of Securities Dealers on Customers in the Over-the-Counter Market.

This Court in *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra,* 414 U.S. 117, has stated that state law does not override the rules of a national securities exchange germane

to investor protection and fair dealing, yet, in this case, the courts below have explicitly reached a contrary result.

The decision below holds that the NASD Rules do not have the same status as do the rules regulating the national exchanges. This holding is contrary to the decision of the Fifth Circuit Court of Appeals in *Harwell v. Growth Programs, Inc.,* 451 F.2d 240, 244 (5th Cir., 1971); mod. 459 F.2d 461; cert. den. 402 U.S. 593, which in reference to the NASD Rules as affecting customers of NASD members said:

> "Anyone dealing in securities today must be charged with the knowledge that they are operating in a closely regulated field in which public interest and public policy play a dominant part."
>
> *Harwell v. Growth Programs, Inc.,* 451 F.2d 240, 244 (5th Cir., 1971); mod. 459 F.2d 461; cert. den. 402 U.S. 593.

On this same point the decision below conflicts with the decisions of the district courts in *Financial House, Inc. v. Otten,* 369 F.Supp. 105 (D.C.Mich., 1973), holding that an arbitration rule adopted by the NASD was binding on both the broker and the customers; and *Bache & Co. v. Clay,* 366 F.Supp. 1248, 1251 (D.C.Okla., 1973) holding that a trading rule of the NASD was binding on the brokerage customer. The *Bache* court, at footnote 4, p. 1251, noted that the NASD Rules have the force of law.

The decision below to the extent that it applies California law instead of NASD Rules, also conflicts with the Fifth Circuit's holding in *Harwell* that the Maloney Act[5] prevails

5. The 1938 amendment to the Securities Exchange Act of 1934 providing for registration of national securities associations, 15 USC 78o-3.

over other laws to the extent that they conflict. *Harwell v. Growth Programs, Inc., supra,* 451 F.2d 240, 247. Since the precedent in California, established by the decision below, makes conduct required by the NASD Rules violative of California law, it seems undeniable that the decision below is in conflict with the Fifth Circuit's decision in *Harwell* just as California law now conflicts with the Maloney Act.

These conflicts justify the grant of certiorari to review the decision below.

III. The Decision Below Deprives Customers of the Protection Intended by the Securities Exchange Act.

The Securities Exchange Act of 1934 was adopted to protect investors trading on the securities markets of this country. The Maloney Act amended the Securities Exchange Act to provide a scheme of regulation for the vast over-the-counter market. This scheme, founded on 15 U.S.C. § 78o-3 and discussed in more detail above, requires the NASD to adopt and enforce rules designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to protect investors and the public interest and to remove impediments to and perfect the mechanism of a free and open market. (15 U.S.C. § 78o-3(b)(8).) This purpose is effectuated through the Rules and Interpretations of the NASD.

The decision below impairs the implementation of the Maloney Act by holding that, in the California based over-the-counter market, the NASD Rules and Interpretations do not bind the NASD member's customers and do not provide the NASD member with a defense against liability for complying with those rules.

The instant case is a good example of a customer being deprived of the protection of the Act. Here Mrs. Mann is

being held to a contract on the basis of California law because she agreed to sell and other people offered to purchase certain stock. Implicit throughout the federal securities law are the ideas of full disclosure and fairness in trading. These ideas support the NASD Interpretation requiring the price of a security to be reasonably related to the current market price; however, the laws of contract have been developed in a very different environment: an environment of arms-length transactions with each party making his own investigation as to fairness and value. Even among securities dealers, who should be among the best informed investors in securities, a bid or offer made through inter-dealer quotations do not constitute an "offer" in the normal contract sense when there has been a material change in the market condition. As stated by Professor Loss:

> "Clearly, therefore, a bid or offer in the sheets might well be *bona fide* within the NASD rule at the time of its entry and yet not constitute an 'offer' that can be accepted prior to its withdrawal *as a matter of contract law* when, say, there has been a material change of market conditions overnight."
>
> Loss, *Securities Regulation,* 2d Ed., Supplement 1969, Vol. V, p. 3321.

Persons such as Mrs. Mann need the protection of the NASD Rules and in particular they need the assurance that the price of the securities which they are buying or selling is reasonably related to the current market price. When dealing in listed securities or securities actively traded over-the-counter, an investor can gauge the fairness of the price from information in the newspapers; however, no such information is available in regard to the value of infrequently traded stock such as is involved here.

To hold, as have the courts below, that a broker does not have the responsibility of investigating to determine the fairness of the stock's price deprives investors such as Mrs. Mann of the protection which they have come to rely upon and constitutes a trap for the innocent. The Maloney Act requires a different result.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the California Court of Appeal.

Dated: August 29, 1975.

Respectfully submitted,

BRONSON, BRONSON & MCKINNON

By PAUL H. CYRIL

(Appendix Follows)

Appendix

[Civ. No. 34258. First Dist., Div. Three. Apr. 10, 1975.]

HERBERT NEWMAN, Plaintiff and Respondent, v. FIRST CALIFORNIA COMPANY et al., Defendants and Appellants.

SUMMARY

A prospective buyer of stock in a savings and loan association brought an action against the stockbroker and the seller of the stock for damages for breach of contract and negligence in failing to carry out the sale. It appeared from the evidence that the broker had obtained an agreement between the buyer and seller for sale of the stock at an agreed price, had sent matching buy and sell orders for the stock to his office, and had told the buyer that the order had gone through and that the shares would be confirmed in his name, without mentioning any conditions that had to be met. Four days later however, when the buyer checked on the sale, the broker said the sale would not be confirmed as a merger involving the savings and loan association had just been announced and that the agreed price of the stock was thus no longer fair. At the trial, the broker attempted to assert as a defense that rules and regulations of the National Association of Securities Dealers required a broker's independent investigation of fairness as a condition of sale, but the trial court ruled that in the absence of a showing that a binding regulation to that effect existed, the rules would not be allowed in evidence. Thereafter, the jury returned a verdict in favor of the buyer. (Superior Court of the City and County of San Francisco, No. 627-422, Bernard B. Glickfeld, Judge.)

The Court of Appeal affirmed. The court held that no National Association of Securities Dealer's rules required the broker's independent investigation of the fairness of price under the circumstances of the parties' having negotiated and agreed on a price, and that even if such a rule existed, the fairness of price would relate to the date the sale was confirmed, not the later date when the merger was announced. The court also held that it was not error for the trial court to refuse an instruction requested by the broker concerning his duty of investigation under the alleged rules, since no such rule existed. The court further held that misconduct of the judge in interjecting his own view of the case would not be deemed prejudicial, where such views were only concerned with the independent investigation defense attempted to be asserted by the broker, and it was thus not reasonably probable that there would have been a result more favorable to the broker in the absence of the asserted misconduct. (Opinion by Good, J.,* with Brown (H. C.), Acting P. J., and Scott, J., concurring.)

HEADNOTES

Classified to California Digest of Official Reports, 3d Series

(1) Securities Regulations § 11—Corporate Securities Law —Agents and Brokers—Duties and Liabilities.—There is no binding rule of the National Association of Securities Dealers requiring a broker's independent investigation of the fairness of price of a rarely traded, unlisted stock. Thus, in an action by a buyer against a broker and seller for damages for failure to carry out an agreed sale of shares of a savings and loan association, the trial court properly refused to allow the

*Retired judge of the superior court sitting under assignment by the Chairman of the Judicial Council.

broker to assert the alleged requirement as a defense. [See Cal.Jur.2d, Brokers, § 49; Am.Jur.2d, Brokers, § 119.]

(2) Securities regulation § 11—Corporate Securities Law —Agents and Brokers—Duties and Liabilities.—A complaint by a prospective purchaser of unlisted stock in a savings and loan association, against the seller and broker for failure to go through with the agreed sale because the agreed price was no longer fair in view of an announced merger involving the savings and loan association, stated a cause of action for negligence where, prior to the merger, the broker had obtained matching buy and sell orders for the stock from the buyer and seller, which put him under an obligation to complete the transaction with reasonable diligence. Any duty the broker had to independently investigate the fairness of price would relate to the price as of the date the sale was confirmed, and not as of the later date when the merger was announced, since the merger was a future event that neither buyer, seller or broker could predict, and its impact on the price thus did not affect the fairness of the price on the prior date the sale was confirmed.

(3) Securities Regulation § 15—Corporate Securities Law —Agents and Brokers—Trial—Instructions.—It is reversible error to refuse to instruct the jury on a party's theory of the case only when that theory is supported by the pleadings and evidence. Thus, in an action by a buyer against a broker and seller for damages for failure to complete an agreed sale of stock, it was not error for the trial court to refuse instructions requested by the broker concerning an asserted duty under the National Association of Securities Dealers rules re-

quiring him to independently investigate the fairness of the price of the stock, where the rule simply did not exist. The fact that defendants testified to such a duty did not raise a question of fact when they could not produce any law or regulation that imposed the duty, and thus the trial court's acceptance of plaintiff's expert testimony that no such duty existed was not a matter of weighing the evidence, but was a correct decision on a question of law.

(4) Securities Regulations § 13—Corporate Securities Law —Agents and Brokers—Contracts Respecting Purchase and Sale.—An intention on the part of a buyer of stock to make a gift of a portion of the stock for his children had no effect on the measure of damages recoverable against a broker and seller for negligent failure to complete the sale, and the buyer was entitled to recovery in respect to all the stock involved, where the intention to make the gift was not made part of the sale nor incorporated into the purchase order, and the stock was to be confirmed in the buyer's name.

(5) Appellate Review § 176—Harmless Error—Conduct of Court.—On appeal from a judgment in favor of a prospective buyer of stock against the broker and seller for failure to complete the sale, misconduct on the part of the trial judge in interjecting his own view of the case would not be deemed prejudicial, where the interjections were concerned only with a defense asserted by the broker that had no basis in law, and it was thus not reasonably probable that there would have been a result more favorable to defendants in the absence of the asserted misconduct.

COUNSEL

Bronson, Bronson & McKinnon and Paul Cyril for Defendants and Appellants.

Maloney, Chase, Fisher & Hurst and James T. Hurst for Plaintiff and Respondent.

OPINION

GOOD, J.*—This is an appeal from a judgment upon a jury verdict awarding respondent Newman $42,461. The complaint charged appellants First California Company, Leonard Talbot, a stockbroker, and its employee, and Mrs. Ned F. Mann with breach of contract and negligence in relation to Newman's attempted purchase of 30 shares of Modesto Savings and Loan Association (Modesto Savings, *post*).

On or about February 10, 1969, Talbot informed Newman at respondent's Santa Rosa office that a $40,000 profit might be made on a purchase of stocks that he thought he could arrange. Newman said he would think it over. Meanwhile Talbot contacted Ned F. and Mary Mann and on February 14 secured their written authorization to sell 101 shares of Modesto Savings at $500 per share net to them.[1]

On the same date, the Manns gave First California a similar authorization to sell 47 shares of Modesto Holding Company at $60 a share. This latter stock was not part of any dealing between Newman and First California. The

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*Retired judge of the superior court sitting under assignment by the Chairman of the Judicial Council.

[1]This authorization reads:

"This is your authorization to sell 101 shares of Modesto Savings and Loan at a price of $500.00. It is understood the $500.00 will be after deducting your 3% commission so that I net $500.00.

In understand that there is a 'work out' market in the stock and that First California Company also represents the Buyer in this agency transaction."

Manns had instructed that the two sales were to be dependent upon each other. On February 17, when Newman placed his written order for 30 shares of Modesto Savings at $530, the price named by Talbot, Talbot had orders for all of the Mann stock in both companies. This order to buy was prepared by Talbot and contained the work out and dual agency references spelled out in the last paragraph of the order to sell (See fn. 1, *supra.*)

Some four months before this, Talbot himself had bought a block of Modesto Savings from Mrs. Mann's daughter at $500 per share net, along with her holding company stock which was finally sold for about $50 per share. On February 12 First California had sold a block of Modesto Savings at the same price quoted to Newman. Talbot testified that he discussed prices with the Manns and explained to them a $10 increase in the price of the holding company shares was justified because of an intervening dividend of $5 per share.

On February 17 Talbot teletyped to First California's San Francisco office the matching buy and sell orders for all of the Manns' stock. On the same day he left a telephoned message for Newman that the deal was going through and details would follow in a day or two. He also wrote a brief confirming letter: "Your order has gone thru. The 30 shares will be confirmed in your name." Later that day Talbot went to Newman's office and had him sign the order to buy 30 shares. Talbot said he had made a special trip and had secured the stock and told Newman, "you've got a deal." He did not mention any conditions that had to be met. Newman understood the sale was complete except for registration, transfer and issuance of new certificates in his name.

On February 21 Newman went to Talbot's office to check on the sale. Talbot showed him a press announcement of the merger of Modesto Savings and Loan with Golden West Financial. Newman still wanted to know where the stock was. Talbot said they were not confirming it because the price was no longer fair.

At the trial there was considerable confusion over the meanings of "work out market" and "over-the-counter" transactions. There was a conflict in the testimony over the definition of "work out" market. The National Association of Securities Dealers, Inc. (NASD) manual does not define it. First California claims it refers to sales where it is difficult to ascertain market price because the stocks are rarely traded. They claimed that as members of NASD they were required to make an independent investigation of the price for fairness to both sides despite the fact the price had been agreed upon in the negotiations with sellers and buyer.

The bone of contention was whether, in the existing circumstances, NASD rules and regulations required the broker's independent investigation of fairness as a condition of sale in addition to pertinent requirements of state and federal law. The judge stated in chambers that merely belonging to a self-regulating group did not "replace California law or the requirements of the SEC, or the State Securities Brokers law." He clearly stated that unless First California could show him a binding regulation to that effect he would not allow NASD rules in evidence. Unfortunately, the testimonial confusion and counsel's failure to accept or, perhaps, understand the judge's ruling were the occasion of many exchanges before the jury and interventions by the judge to question counsel and witnesses

throughout the course of the trial. The record presents the following issues on appeal:

1. Do NASD rules require a broker's independent investigation of the fairness of price of a rarely traded stock in a work out market? No.

(1) The instant sale was an over-the-counter transaction. The over-the-counter market is deemed to include all transactions in securities which take place other than upon a national exchange. (5 Loss, Securities Regulation (Supp. to 2d ed. 1969) p. 3313.) Appellants cite cases holding that a person trading on an exchange is bound by contract to its rules and customs. (*Cisler v. Ray* (1931) 213 Cal. 620, 628 [2 P.2d 987, 79 A.L.R. 584]; *Liberman v. McDonnell* (1929) 97 Cal.App. 171, 178 [275 P. 486]; *Bennett v. Logan & Bryan* (1927) 80 Cal.App. 571, 580 [252 P. 662].) They are not applicable because the subject transaction was not on an exchange. The NASD was established by the Maloney Act in 1938 as a self-regulating association of members who participate in over-the-counter market transactions. Membership is not mandatory but carries privileges to participate on a preferential basis. (NASD Manual (1973) ¶¶ 101-102, pp. 109-110.) Appellants have failed to demonstrate that NASD rules have the same status as those regulating the national exchanges. Further, they failed to demonstrate at trial or in this court that they had the alleged duty to investigate under these rules.

The regulations relied upon as establishing the duty to set the price are NASD Rules of Fair Practice, article III, sections 1 and 12. (NASD Manual, article III, ¶¶ 2151 and 2162.) Section 1 requires members to "observe high standards of commercial honor and just and equitable principles of trade." An interpretation by the NASD Board of Gov-

ernors as to retail over-the-counter transactions says that "a member . . . shall use reasonable diligence to ascertain the best *inter-dealer market* for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions." [Italics supplied.] This notation was not brought to the attention of the trial court and was not argued here. If it was applicable at all, it appears to us that any duty to investigate an interdealer market for Modesto Savings would have to be discharged before a broker procured binding offers to sell or buy. Section 12 relates to a broker's duty to disclose his capacity in the transaction, i.e., as broker for one or both parties or as dealing in his own capacity as well as other information not here pertinent.

Appellants also claim that there is case authority for their proposition that the contract was not complete until the broker verified the price. The only case cited is *In the Matter of Samuel B. Franklin & Co.* (1957-1961 CCH Fed. Sec. L. Rep. ¶ 76,647). It is not in point. It affirmed a disciplinary action against a brokerage firm for charging excessive markups or markdowns on stocks for which there were readily ascertainable market prices. There is a precise NASD rule governing this problem, rule 4 (NASD Manual, art. III, ¶ 2154), which applies to "over-the-counter transactions" in listed or unlisted securities and requires a member who either buys or sells for his own account to do so at a price which is fair to the customer.

This requirement is clearly limited to cases where the member broker deals on his own account. Concededly, it imposes a duty to investigate "market conditions at the time of the transaction" and to determine fairness of price if the broker is to escape NASD's censure or possible civil

liability to customer for breach of fiduciary duty. The presence of that requirement as an NASD rule and its limitation to an interdealer transaction argues that such investigation is not required in an arm's length deal between a willing buyer and seller who have agreed upon price.

Appellants also rely on the fact that the sellers wanted to sell all the stock or none. They argue there was a change in the holding company stock from the previous sale; therefore its price must be investigated and all the sales held up in the meantime. Talbot claims to have informed Newman of this condition; Newman denied this and we must assume the jury resolved the conflict in his favor. Because the condition did not exist under any NASD regulation we have been able to discover, appellant's argument fails. The condition, if it existed in Talbot's mind, was never disclosed to either buyer or seller. Had it existed, it would at most be an undisclosed term that did not become part of the contract. (Cf. *Horacek v. Smith* (1948) 33 Cal.2d 186, 193-194 [199 P.2d 929].)

(2) The buyer's complaint stated a cause of action for negligence. The matching buy and sell orders for all of the Mann stock put the broker under an obligation to complete the transaction with reasonable diligence. If there was a duty to investigate fairness of price as of February 17, the price of the same stock at a sale consummated on February 12 was of record in First California's office. It, as well as the four months old sale, was discoverable, according to First California's transfer officer's testimony, in less than half an hour. The transfer agent also admitted the obvious, i.e., that fairness of price was to be determined as it existed on February 17. The merger announced on February 20 or 21 was a future event that neither buyer, seller or broker could predict. Impending mergers are usually known only to a small circle of trusted executives of the corporations involved and are not discoverable by others until public announcement is made. There is no inference that buyer or seller had inside information on February 17 or that the broker could have secured access thereto. The merger's impact on price occurred after its announcement and did not affect the fairness of price on February 17.

2. Did the court erroneously refuse to instruct on the duty of a broker and the measure of damages? No.

(3) As to the broker's duty, it is reversible error to refuse to instruct a jury on a party's theory of the case only when that theory is supported by the pleadings and evidence. (*Phillips v. G. L. Truman Excavation Co.* (1961) 55 Cal.2d 801 [13 Cal.Rptr. 401, 362 P.2d 33].) In this case there was testimony about the duty, which was supposed to rest on NASD rules. But the rule simply did not exist. In such a circumstance, though appellants requested the instruction, it was not error to refuse it. The judge instructed the jury that a broker is a fiduciary who owes the highest good faith and integrity to his customer.

First California's witnesses, as experts, testified to their duty to investigate and plaintiff's expert testified there was no such duty. The judge's acceptance of the latter was not a matter of weighing the evidence. It was a correct decision on a question of law. The fact that defendants testified to such a duty did not raise a question of fact when they could not produce any law or regulation that imposes such a duty and would be a defense to a breach of contract action or remove the stigma of negligence from the unjustified delay in closing the sale.

(4) The measure of damages issue arises out of appellant's contention that it was error to refuse to instruct that 10 shares which respondent intended to buy for his children should not be considered by the jury. Respondent testified that 10 of the 30 shares were intended for his children. They were to be in his name as custodian under the Uniform Gifts to Minors Act. In February 1969 the eldest child was 20. The age of majority was then 21. (Civ. Code, § 25.1.) The Uniform Gifts to Minors Act states that the custodian holds in trust all rights and powers of a guardian. (Civ. Code, § 1158, subd. (i).) A minor may enforce his rights, but the action must be brought by his guardian. (Civ. Code, § 42.)

But this intention was not made part of the sale and was not incorporated into the purchase order which was placed in a single block. Newman alone signed the buy authorization. Talbot's letter of February 17, though never sent because he went to Newman's office, said the shares would be confirmed in plaintiff's name. It was not error to refuse this instruction.

3. Did the judge's comments constitute prejudicial misconduct and violate appellant's right to a jury trial? No.

(5) Appellants cite several instances of judicial misconduct. It is misconduct for a judge to make comments which indicate more than a slight leaning to one side. (*Davis v. Pezel* (1933) 131 Cal.App. 46 [20 P.2d 982].) The judge repeatedly emphasized that the contract was governed by California law. The interpolations were lengthy and sometimes sarcastic. Although some of them were proper in order to clarify to the jury the concepts of "over-the-counter," "work out" markets, and the manner in which a

sale is finally completed, we do not agree with respondent's contention that they were invited by counsel's persistence in pursuing a phantom defense.

This is admittedly a close case on the misconduct issue because the judge so thoroughly interjected his own view of the case, but only as concerned the asserted defense. On balance, because the defense did not exist, the misconduct is not deemed prejudicial. Under the evidence and the law, it is not reasonably probable that there would have been a result more favorable to appellant in the absence of the asserted misconduct. (*People v. Watson* (1956) 46 Cal.2d 818, 836 [299 P.2d 243]; *Delzell v. Day* (1950) 36 Cal.2d 349, 352 [223 P.2d 625].)

The judgment is affirmed. Respondent is to recover costs.

Brown (H. C.), Acting P. J., and Scott, J., concurred.

NASD Rules of Fair Practice
Business Conduct of Members

Article III, Sec. 1. A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade. CCH NASD Securities Dealers Manual ¶ 2151.

NASD Rules of Fair Practice
Fair Prices and Commissions

Article III, Sec. 4. In "over-the-counter" transactions, whether in "listed" or "unlisted" securities, if a member buys for his own account from his customer, or sells for his own account to his customer, he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit; and if he acts as

agent for his customer in any such transaction, he shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor. CCH NASD Securities Dealers Manual ¶ 2154.

NASD Rules of Fair Practice

"The completion of the transaction"
Article II, Sec. 1.

(j) The term "the completion of the transaction" means:

(1) In the case of a customer who purchases a security through or from a member, except as provided in paragraph (2), the time when such customer pays the member any part of the purchase price, or, if payment is effected by a bookkeeping entry, the time when such bookkeeping entry is made by the member for any part of the purchase price;

(2) In the case of a customer who purchases a security through or from a member and who makes payment therefor prior to the time when payment is requested or notification is given that payment is due, the time when such member delivers the security to or into the account of such customer;

(3) In the case of a customer who sells a security through or to a member, except as provided in paragraph (4), if any security is not in the custody of the member at the time of sale, the time when the security is delivered to the member, and if the security is in the custody of the member at the time of sale, the time when the member transfers the security from the account of such customer;

(4) In the case of a customer who sells a security through or to a member and who delivers such security to such member prior to the time when delivery is requested or notification is given that delivery is due, the time when such member makes payment to or into the account of such customer. CCH NASD Securities Dealers Manual ¶ 2101 p 2013.

In accordance with Article VII, Section 3(a) of the By-Laws, the following interpretation under Article III, Sections 1 and 4 of the Rules of Fair Practice has been adopted by the Board:

It shall be deemed conduct inconsistent with just and equitable principles of trade for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security or to charge a commission which is not reasonable. CCH NASD Securities Dealers Manual ¶ 2154, p 2056.

§ 78b. Necessity for regulation

For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Fed-

eral Reserve System, and to insure the maintenance of fair and honest markets in such transactions:

(1) Such transactions (a) are carried on in large volume by the public generally and in large part orginate outside the States in which the exchanges and over-the-counter markets are located and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit.

(2) The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.

(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities,

and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

June 6, 1934, c. 404, § 2, 48 Stat. 881.

§ 78f. Registration of national securities exchanges

(a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:

(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this chapter, and any amendment thereto and any rule or regulation made or to be made thereunder;

(2) Such data as to its organization, rules or procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;

(3) Copies of its constitution, articles of incorporation with all amendments thereto, and of its existing bylaws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the "rules of the exchange"; and

(4) An agreement to furnish to the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption.

(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this chapter or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

(c) Nothing in this chapter shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this chapter and the rules and regulations thereunder and the applicable laws of the State in which it is located.

(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this chapter and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange.

(e) Within thirty days after the filing of the application, the Commission shall enter an order either granting or, after appropriate notice and opportunity for hearing, denying registration as a national securities exchange, unless the exchange applying for registration shall withdraw its

application or consent to the Commission's deferring action on its application for a stated longer period after the date of filing. The filing with the Commission of an application for registration by an exchange shall be deemed to have taken place upon the receipt thereof. Amendments to an application may be made upon such terms as the Commission may prescribe.

(f) An exchange may, upon appropriate application in accordance with the rules and regulations of the Commission, and upon such terms as the Commission may deem necessary for the protection of investors, withdraw its registration.

June 6, 1934, c. 404, § 6, 48 Stat. 885.

§ 78*o*—3. Over-the-counter brokers' and dealers' associations; registration—Association registration; national or affiliated; data

(a) Any association of brokers or dealers may be registered with the Commission as a national securities association pursuant to subsection (b) of this section, or as an affiliated securities association pursuant to subsection (d) of this section, under the terms and conditions hereinafter provided in this section, by filing with the Commission a registration statement in such form as the Commission may prescribe, setting forth the information, and accompanied by the documents, below specified:

(1) Such data as to its organization, membership, and rules of procedure, and such other information as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors; and

(2) Copies of its constitution, charter, or articles of incorporation or association, with all amendments thereto, and of its existing bylaws, and of any rules

or instruments corresponding to the foregoing, whatever the name, hereinafter in this chapter collectively referred to as the "rules of the association."

Such registration shall not be construed as a waiver by such association or any member thereof of any constitutional right or of any right to contest the validity of any rule or regulation of the Commission under this chapter.

Prerequisites to national registration; association rules

(b) An applicant association shall not be registered as a national securities association unless it appears to the Commission that—

(1) by reason of the number of its members, the scope of their transactions, and the geographical distribution of its members such association will be able to comply with the provisions of this chapter and the rules and regulations thereunder and to carry out the purposes of this section.

(2) such association is so organized and is of such a character as to be able to comply with the provisions of this chapter and the rules and regulations thereunder, and to carry out the purposes of this section.

(3) the rules of the association provide that any broker or dealer who makes use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security otherwise than on a national securities exchange, may become a member of such association, except such as are excluded pursuant to paragraph (4) or (5) of this subsection, or a rule of the association permitted under this paragraph. The rules of the association may restrict membership in such association on such specified geographical basis,

or on such specified basis relating to the type of business done by its members, or on such other specified and appropriate basis, as appears to the Commission to be necessary or appropriate in the public interest or for the protection of investors and to carry out the purpose of this section. Rules adopted by the association may provide that the association may, unless the Commission directs otherwise in cases in which the Commission finds it appropriate in the public interest so to direct, deny admission to or refuse to continue in such association any broker or dealer if—

(A) such broker or dealer, whether prior or subsequent to becoming such, or

(B) any person associated with such broker or dealer, whether prior or subsequent to becoming so associated,

has been and is suspended or expelled from a national securities exchange or has been and is barred or suspended from being associated with all members of such exchange, for violation of any rule of such exchange.

(4) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no broker or dealer shall be admitted to or continued in membership in such association, if such broker or dealer—

(A) has been and is suspended or expelled from a registered securities association (whether national or affiliated) or from a national securities exchange or has been and is barred or suspended from being associated with all members of such association or

from being associated with all brokers or dealers which are members of such exchange, for violation of any rule of such association or exchange which prohibits any act or transaction constituting conduct inconsistent with just and equitable principles of trade, or requires any act the omission of which constitutes conduct inconsistent with just and equitable principles of trade.

(B) is subject to an order of the Commission denying, suspending for a period not exceeding twelve months, or revoking his registration pursuant to section 78*o* of this title, or expelling or suspending him from membership in a registered securties association or a national securities exchange, or barring or suspending him from being associated with a broker or dealer.

(C) whether prior or subsequent to becoming a broker or dealer, by his conduct while associated with a broker or dealer, was a cause of any suspension, expulsion, or order of the character described in clause (A) or (B) which is in effect with respect to such broker or dealer, and in entering such a suspension, expulsion, or order, the Commission or any such exchange or association shall have jurisdiction to determine whether or not any person was a cause thereof.

(D) has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person who, if such person were a broker or dealer, would be ineligible for admission to or continuance in membership under clause (A), (B), or (C) of this paragraph.

(5) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no person shall become a member and no natural person shall become a person associated with a member, unless such person is qualified to become a member or a person associated with a member in conformity with specified and appropriate standards with respect to the training, experience, and such other qualifications of such person as the association finds necessary or desirable, and in the case of a member, the financial responsibility of such member. For the purpose of defining such standards and the application thereof, such rules may—

(A) appropriately classify prospective members (taking into account relevant matters, including type of business done and nature of securities sold) and persons proposed to be associated with members.

(B) specify that all or any portion of such standards shall be applicable to any such class.

(C) require persons in any such class to pass examinations prescribed in accordance with such rules.

(D) provide that persons in any such class other than prospective members and partners, officers and supervisory employees (which latter term may be defined by such rules and as so defined shall include branch managers of members) of members, may be qualified solely on the basis of compliance with specified standards of training and such other qualifications as the association finds appropriate.

(E) provide that applications to become a member or a person associated with a member shall set forth such facts as the association may prescribe as to the training, experience, and other qualifications (including, in the case of an applicant for membership, financial responsibility) of the applicant and that the association may adopt procedures for verification of qualifications of the applicant.

(F) require any class of persons associated with a member to be registered with the association in accordance with procedures specified by such rules (and any application or document supplemental thereto required by such rules of a person seeking to be registered with such association shall, for the purposes of subsection (a) of section 78ff of this title, be deemed an application required to be filed under this chapter).

(6) the rules of the association assure a fair representation of its members in the adoption of any rule of the association or amendment thereto, the selection of its officers and directors, and in all other phases of the administration of its affairs.

(7) the rules of the association provide for the equitable allocation of dues among its members, to defray reasonable expenses of administration.

(8) the rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect

the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges.

(9) the rules of the association provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules.

(10) the rules of the association provide a fair and orderly procedure with respect to the disciplining of members and persons associated with members and the denial of membership to any broker or dealer seeking membership therein or the barring of any person from being associated with a member. In any proceeding to determine whether any member or other person shall be disciplined, such rules shall require that specific charges be brought; that such member or person shall be notified of, and be given an opportunity to defend against, such charges; that a record shall be kept; and that the determination shall include—

(A) a statement setting forth any act or practice in which such member or other person may be found to have engaged, or which such member or other person may be found to have omitted.

(B) a statement setting forth the specific rule or rules of the association of which any such act or practice, or omission to act, is deemed to be in violation.

(C) a statement whether the acts or practices prohibited by such rule or rules, or the omission of any act required thereby, are deemed to constitute conduct inconsistent with just and equitable principles of trade.

(D) a statement setting forth the penalty imposed.

In any proceeding to determine whether a broker or dealer shall be denied membership or whether any person shall be barred from being associated with a member, such rules shall provide that the broker or dealer or person shall be notified of, and be given an opportunity to be heard upon, the specific grounds for denial or bar which are under consideration; that a record shall be kept; and that the determination shall set forth the specific grounds upon which the denial or bar is based.

(11) the requirements of subsection (c) of this section, insofar as these may be applicable, are satisfied.

(12) the rules of the association include provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange which may be disseminated by any member or any person associated with a member, and the persons to whom such quotations may be supplied. Such rules relating to quotations shall be designed to produce fair and informative quotations, both at the wholesale and retail level, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting and publishing quotations.

The provisions of this subsection, as in effect prior to August 20, 1964, shall be applicable to the rules of any registered securities association which was registered on such date until July 1, 1964. After July 1, 1964, the Commission may, after notice and opportunity for hearing, suspend the registration of any such association if it finds that the rules thereof do not conform to the requirements of this subsection, as amended by section 7 of the Securities Acts Amendments of 1964, and any such suspension shall remain in effect until the Commission issues an order determining that such rules have been modified to conform with such requirements.

National association rules; provision for registration of affiliated securities association

(c) The Commission may permit or require the rules of an association applying for registration pursuant to subsection (b) of this section, to provide for the admission of an association registered as an affiliated securities association pursuant to subsection (d) of this section, to participation in said applicant association as an affiliate thereof, under terms permitting such powers and responsibilities to such affiliate, and under such other appropriate terms and conditions, as may be provided by the rules of said applicant association, if such rules appear to the Commission to be necessary or appropriate in the public interest or for the protection of investors and to carry out the purposes of this section. The duties and powers of the Commission with respect to any national securities association or any affiliated securities association shall in no way be limited by reason of any such affiliation.

Registration as affiliated association; prerequisites; association rules

(d) An applicant association shall not be registered as an affiliated securities association unless it appears to the Commission that—

(1) such association, notwithstanding that it does not satisfy the requirements set forth in paragraph (1) of subsection (b) of this section, will, forthwith upon the registration thereof, be admitted to affiliation with an association registered as a national securities association pursuant to subsection (b) of this section, in the manner and under the terms and conditions provided by the rules of said national securities association in accordance with subsection (c) of this section; and

(2) such association and its rules satisfy the requirements set forth in paragraphs (2) to (10), inclusive, and paragraph (12), of subsection (b) of this section; except that in the case of any such association any restrictions upon membership therein of the type authorized by paragraph (3) of subsection (b) of this section shall not be less stringent than in the case of the national securities association with which such association is to be affiliated.

Granting and denying registration; revocation of affiliated association registration

(e) Upon the filing of an application for registration pursuant to subsection (b) or (d) of this section, the Commission shall by order grant such registration if the requirements of this section are satisfied. If, after appropriate notice and opportunity for hearing, it appears to the Commission that any requirement of this section is not satisfied, the Commission shall by order deny such registration. If any association granted registration as an affiliated securities association pursuant to subsection (d) of this section shall fail to be admitted promptly thereafter to affiliation with a registered national securities association, the Commission shall revoke the registration of such affiliated securities association.

Withdrawal from registration

(f) A registered securities association (whether national or affiliated) may, upon such reasonable notice as the Commission may deem necessary in the public interest or for the protection of investors, withdraw from registration by filing with the Commission a written notice of withdrawal in such form as the Commission may by rules and regulations prescribe. Upon the withdrawal of a national securities association from registration, the registration of any association affiliated therewith shall automatically terminate.

Review by Commission of adverse action against association members; stay of action

(g) If any registered securities association (whether national or affiliated) takes any disciplinary action against any member thereof or any person associated with such a member or denies admission to any broker or dealer seeking membership therein, or bars any person from being associated with a member, such action shall be subject to review by the Commission, on its own motion, or upon application by any person aggrieved thereby filed within thirty days after such action has been taken or within such longer period as the Commission may determine. Application to the Commission for review, or the institution of review by the Commission on its own motion, shall operate as a stay of such action until an order is issued upon such review pursuant to subsection (h) of this section, unless the Commission otherwise orders, after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of affidavits and oral arguments).

Commission's action upon findings

(h)(1) In a proceeding to review disciplinary action taken by a registered securities association against a member thereof or a person associated with a member, if the Commission, after appropriate notice and opportunity for hearing, upon consideration of the record before the association and such other evidence as it may deem relevant—

(A) finds that such member or person has engaged in such acts or practices, or has omitted such act, as the association has found him to have engaged in or omitted, and

(B) determines that such acts or practices, or omission to act, are in violation of such rules of the association as have been designated in the determination of the association,

the Commission shall by order dismiss the proceeding, unless it appears to the Commission that such action should be modified in accordance with paragraph (2) of this subsection. The Commission shall likewise determine whether the acts or practices prohibited, or the omission of any act required, by any such rule constitute conduct inconsistent with just and equitable principles of trade, and shall so declare. If it appears to the Commission that the evidence does not warrant the finding required in clause (A), or if the Commission determines that such acts or practices as are found to have been engaged in are not prohibited by the designated rule or rules of the association, or that such act as is found to have been omitted is not required by such designated rule or rules, the Commission shall by order set aside the action of the association.

(2) If, after appropriate notice and opportunity for hearing, the Commission finds that any penalty imposed upon a member or person associated with a member is excessive or oppressive, having due regard to the public interest, the Commission shall by order cancel, reduce, or require the remission of such penalty.

(3) In any proceeding to review the denial of membership in a registered securities association or the barring of any person from being associated with a member, if the Commission, after appropriate notice and hearing, and upon consideration of the record before the association and such other evidence as it may deem relevant, determines that the specific grounds on which such denial or bar is based exist in fact and are valid under this section, the Commission shall by order dismiss the proceeding; otherwise, the Commission shall by order set aside the action of the association and require it to admit the applicant broker or dealer to membership therein, or to permit such person to be associated with a member.

Dealings with nonmember brokers or dealers

(i)(1) The rules of a registered securities association may provide that no member thereof shall deal with any nonmember broker or dealer (as defined in paragraph (2) of this subsection) except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.

(2) For the purposes of this subsection, the term "nonmember broker or dealer" shall include any broker or dealer who makes use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security otherwise than on a national securities exchange, who is not a member of any registered securities association, except a broker or dealer who deals exclusively in commercial paper, bankers' acceptances, or commercial bills.

(3) Nothing in this subsection shall be so construed or applied as to prevent any member of a registered securities association from granting to any other member of any registered securities association any dealer's discount, allowance, commission, or special terms.

Filing changes or additions to association rules and current information

(j) Every registered securities association shall file with the Commission in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, copies of any changes in or additions to the rules of the association, and such other information and documents as the Commission may require to keep current or to supplement the registration statement and documents filed pursuant to subsection (a) of this section. Any change in or addition to the rules of a registered securities association shall take effect upon the thirtieth day after the filing of a copy thereof with the Commission, or upon such earlier date as the Commission may determine, unless the Commission shall enter an order disapproving such change or addition; and the Commission shall enter such an order unless such change or addition appears to the Commission to be consistent with the requirements of subsections (b) and (d) of this section.

Abrogation and alteration of association rules; supplement to association rules

(k) (1) The Commission is authorized by order to abrogate any rule of a registered securities association, if after appropriate notice and opportunity for hearing, it appears to the Commission that such abrogation is necessary or appropriate to assure fair dealing by the members of such association, to assure a fair representation of its members

in the administration of its affairs or otherwise to protect investors or effectuate the purposes of this chapter.

(2) The Commission may in writing request any registered securities association to adopt any specified alteration of or supplement to its rules with respect to any of the matters hereinafter enumerated. If such association fails to adopt such alteration or supplement within a reasonable time, the Commission is authorized by order to alter or supplement the rules of such association in the manner theretofore requested, or with such modifications of such alteration or supplement as it deems necessary if, after appropriate notice and opportunity for hearing, it appears to the Commission that such alteration or supplement is necessary or appropriate in the public interest or for the protection of investors or to effectuate the purposes of this section, with respect to—

(A) the basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member or the disciplining of members or persons associated with members, or the qualifications required for members or natural persons associated with members or any class thereof.

(B) the method for adoption of any change in or addition to the rules of the association.

(C) the method of choosing officers and directors.

(D) affiliation between registered securities associations.

Suspension of association or member; revocation of registration; expulsion of member; removal of officer or director

(l) The Commission is authorized, if such action appears to it to be necessary or appropriate in the public interest

or for the protection of investors or to carry out the purposes of this section—

(1) after appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to revoke the registration of a registered securities association, if the Commission finds that such association has violated any provision of this chapter or any rule or regulation thereunder, or has failed to enforce compliance with its own rules, or has engaged in any other activity tending to defeat the purposes of this section.

(2) after appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to expel from a registered securities association any member thereof, or to suspend for a period not exceeding twelve months or to bar any person from being associated with a member thereof, if the Commission finds that such member or person—

(A) has violated any provision of this chapter or any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was violating with respect to such transaction any provision of this chapter or any rule or regulation thereunder.

(B) has willfully violated any provision of the Securities Act of 1933, as amended, or of any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was willfully violating with respect to such transaction any provision of such Act or rule or regulation.

(3) after appropriate notice and opportunity for hearing, by order to remove from office any officer or director of a registered securities association who, the

Commission finds, has willfully failed to enforce the rules of the association, or has willfully abused his authority.

Exempt securities

(m) Nothing in this section shall be construed to apply with respect to any transaction by a broker or dealer in any exempted security.

Construction with other laws

(n) If any provision of this section is in conflict with any provision of any law of the United States in force on June 25, 1938, the provision of this section shall prevail.

June 6, 1934, c. 404, § 15A, as added June 25, 1938, c. 677, § 1, 52 Stat. 1070, and amended Aug. 20, 1964, Pub.L. 88-467, § 7, 78 Stat. 574-578.

ORDER DUE
June 9, 1975

Filed Jun-4, 1975
Court of Appeal—First App. Dist.
By Clifford C. Porter, Clerk
Deputy

ORDER DENYING HEARING

After Judgment by the Court of Appeal
1st District, Division 3, Civil No. 34258

In the Supreme Court of the State of California
In Bank

NEWMAN

v.

FIRST CALIFORNIA COMPANY ET AL.

Appellants' petition for hearing DENIED.

SUPREME COURT
Filed Jun 4 1975
G. E. BICHEL, Clerk

.....
Deputy

WRIGHT

.....
Chief Justice

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THE COURT: You listen to me.

Don't run away and talk to your client.

MR. FIELDS: I was going to get the regulations.

THE COURT: I don't care about the regulations. You listen to me.

Unless you can make an offer of proof that shows me that at the time in 1969, whenever this took place—in February—that the Modesto Savings and Loan stock was traded over the New York Stock Exchange, the American Stock Exchange, over-the-counter, or any other stock exchange, I am not going to permit this, because it is not subject to the rules of those organizations, if they are not traded there, and it is that simple.

Now, if you can make the offer of proof, we will go into chambers, and if you can't the objection is sustained. We will go onto another subject.

MR. FIELDS: Your Honor, the transaction and all others—

THE COURT: Just answer the question.

MR. FIELDS: May we go into chambers?

THE COURT: And I want to tell you one thing.

When we go into chambers, I have asked you a question, and I want to stick to that question.

(Thereupon, Court and counsel repaired to chambers and the following took place outside the presence of the jury.)

THE COURT: Now, gentlemen, we are in chambers, outside the presence of the jury, and if you can show this Court, or tell this Court—which was not my understanding—and [Page 134] every bit of evidence is to the contrary—that the Modesto Savings and Loan in and about, I'll say, from January of 1969 through the year of 1969—we'll even go that far—or to the time of the merger, we'll say, until June, or August of '69, that that stock was

traded, or was on the open market, through the American Stock Exchange, New York Stock Exchange, over-the-counter, then that's permissible—then we'll go in to this, but if you cannot show it, then we are going to forget it, and the evidence is to the contrary, because, uncontradictedly, your own client has testified—and there is in evidence—that everything here was on a work-out market, which your client, Mr. Talbot, explained was not an open market, but was a rare, closed-type corporation market involving person-to-person transactions.

Now that's all I want to know.

If you can answer those questions "Yes," fine. If you can't, then I've made my ruling.

I am not interested in rules and regulations of the stock exchange for things that aren't traded, because it's not relevant.

We do know that this gentleman, Mr. Talbot, has a Securities Broker's license. I'm sure that he is licensed by the State of California, and by the SEC, and so forth, but unless you can show me—or put some evidence in in this regard—And if you can't, then let's not get into the rules.

MR. FIELDS: All right. I have it right here.

THE COURT: I don't want the rules of the Exchange.

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MR. FIELDS: I'm not giving you the rules of the Exchange.

THE COURT: Just answer my questions, one at a time.

If you can answer, fine, and let's not horse around.

One. Was this stock traded on the American Stock Exchange?

MR. FIELDS: No.

THE COURT: All right. That's one.

Two. Was it traded on the New York Stock Exchange?

MR. FIELDS: No.

THE COURT: Was it traded on the over-the-counter market, at the period I mentioned? Yes or no?

MR. FIELDS: Yes.

Even though it's rarely traded, it's an over-the-counter trade.

THE COURT: You tell me—show me where it's an over-the-counter trade.

MR. FIELDS: I have here the National Association of Securities Dealers Manual, First California Company, and every other broker-dealer who is a member of the National Association of Securities Dealers.

THE COURT: Tell me concerning the over-the-counter statement.

MR. FIELDS: Now, wait—they are subject to the rules of the National Association—

THE COURT: I didn't ask you that.

Now, Mr. Fields, unless you can show me that this was traded over the counter, your motion is denied to put in any proof, and the objection is sustained.

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You see, you are not following me. You are assuming the very thing I am asking about.

You can look at the newspaper right now. Here's the Examiner, or any paper, and there is a column that says "Over-The-Counter—"

MR. FIELDS: But not every stock is listed that is traded over the counter.

THE COURT: Show me where it is traded over the counter?

Don't start out backwards and say it's subject to it. If you can put in evidence by somebody—and I don't care who—that it is over-the-counter, I will permit it.

MR. FIELDS: All right.

Do you want to take Mr. Newman off the stand, and I'll put somebody on right now who can testify that it's traded in that fashion, and that they are subject to the National Association of Securities Dealers rules, which was in my question to Mr. Newman?

THE COURT: Well, he wouldn't know.

The point I am getting at is as long as I have some evidence that it's traded in some transactions which requires some kind—

MR. HURST: The question that I was going to ask, your Honor, the National Association of Securities Dealers rules don't have any application in the case we are trying here today.

MR. FIELDS: That is completely wrong.

THE COURT: Well, that is an issue.

MR. HURST: There are two gentlemen from the NASD

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that say there is nothing that covers this.

MR. FIELDS: All right, I have it right here, if you'd like to see it.

THE COURT: You see, these are all the things you get in here, and I don't know what these things are about, and unless I have some evidence that it does cover it in some way—

And, first, it would have to be something traded in some formal-type of exchange.

Now, "over-the-counter" implies there is an exchange, too, of some kind.

Now, it doesn't mean every stock in the world. There are hundreds and hundreds that are not traded over the counter, and many that are traded over the counter—not the American or New York Exchanges—and are well-recognized market transactions. They are handled through some formal means.

Now, I don't know—if you can produce some testimony—and I don't care how you do it—

I mean, to satisfy me, or if you want to tell me—put on some offer of proof, that somebody will testify to it, it's relevant, if you answer my question—but you are not answering my question.

MR. FIELDS: May I explain my intent?

THE COURT: Well, I don't want you to explain the intent. I want you to answer my question.

MR. FIELDS: Can I show you what I am trying to prove? I did answer your question by saying it is my belief—

THE COURT: Well, your belief is not enough.

I want some actual evidence to show me—not your

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belief. "Beliefs" aren't enough. We are talking about evidence.

MR. FIELDS: This is called an "over-the-counter trade," even though the stock is not regularly traded over the counter, and it is not published in the Chronicle. That doesn't mean it isn't traded over the counter, just because you don't read it in the green sheet every morning.

I believe this trade is called an "over-the-counter trade."

THE COURT: Well, you "believe."

You are an attorney, and that is not enough for me, as to what you believe. We'll have to have some expertise as to what it is—not you. That is not expertise, and you are not testifying.

MR. FIELDS: Let me read you the regulation that I believe our client was subject to in this case, and that is the very nub of this case, and the reason that the trade didn't go through.

THE COURT: They don't determine the law of the State of California—this Securities rule.

MR. FIELDS: This has nothing to do with the law of the State of California.

THE COURT: But that is the law that I am going to instruct on, though.

MR. FIELDS: You will also instruct, I trust, on the regulations of the National Association of Securities Dealers—

THE COURT: I won't, if they are not applicable.

MR. FIELDS: May I read the one which I believe is

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applicable—"Article VII, Section 3(a) of the By-Laws," which states: "The following interpretation—"

THE COURT: Now, when you say "By-Laws," that means certain people are involved in this.

MR. FIELDS: The National Association of Securities Dealers.

THE COURT: Who are the members of this?

MR. FIELDS: They are the ones who censure, who punish, who regulate every broker-dealer in the industry, Judge. It's they who come in and see whether you have been fair-dealing, or not.

THE COURT: It's like the Bar Association?

MR. FIELDS: Yes.

THE COURT: I mean, the local Bars—not the State Bars.

It's not a Federally-constituted organization. It's a national, non-profit corporation that is policing its own members?

MR. FIELDS: May I read the section? It's very short.

THE COURT: That's what it is.

Now, he doesn't belong to it. Maybe First California does, and maybe that's your testimony.

MR. FIELDS: "Article III, of the Rules of Fair Practice," which has been adopted by the Court states:

"It shall be deemed conduct inconsistent with just and equitable principles of trade for a member to enter into

any transaction with a customer in any security at a price not reasonably related to the current market price of the security, [Page 140] or to charge a commission which is not reasonable."

THE COURT: Wait a second now.

That doesn't mean a thing, for this reason: All that says, number one, is what the Commission doesn't like, but that has nothing to do with whether a transaction has been entered into.

He may enter into one, and he may be punished for it, but that doesn't mean that that deal has not been made.

That's number one—

And reasonable at what time? Before or after the fact?

You see, that has nothing to do if at the time before this merger—and apparently your man says: "No, we don't know it—" but if he had known, and he took advantage of Mrs. Mann by knowing it that day; that they were going to have a big deal, and he sold it, or something, at a much lower price, then he is taking advantage of his fiduciary relationship, and they come in as a group and they say: "Hey, look, you belong to our group, and we are going—First California has breached this relationship through your man, Mr. Talbot—"

That has nothing to do with what the State of California, or the United States Government, or anybody else is going to do to this person, or what the law is here, as far as contracts are concerned.

Now, the next point being—that still does not say it's traded over the counter. It doesn't say that this stock is traded over the counter.

MR. FIELDS: This section—

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THE COURT: You listen to me—let me finish.

I'm getting a little tired of you constantly waving your book in front of my eyes.

MR. FIELDS: I never get a chance to say anything.

THE COURT: Because you haven't said anything that's important.

You just let me finish, and please do not interrupt until I have finished speaking, because right now I don't think you know what you are doing, very frankly, in this case so far.

You just listen.

MR. FIELDS: I will listen.

THE COURT: Please don't interrupt.

I said this does not apply in this case so far, because, number one, it applies to a situation which is not applicable to the facts. It does not say this stock is over-the-counter. It does not say that every stock that is traded is over-the-counter. That involves some kind of other deal.

All this statement you read to me says is that this private corporation—non-profit organization—whatever it is, is saying: "You belong to our group, and if you do certain things, we are going to take certain actions."

That does not replace the law of the State of California, or the requirements of the SEC, or the State Securities broker's law.

That does not replace the contract law of the State of California. That does not replace the fiduciary rules that have grown up in the cases and the Codes, which require

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certain things.

Those are the things that are important, and the only thing that I am trying to find out is, sure, this may say that the man shouldn't breach a duty, but that's all it's saying.

The question here is whether, number one, he did breach a duty.

That's saying, if you do, you are going to get spanked on your hands in some way, and it's wrong, and that's just common-sense law.

A fiduciary, whether he is a stockbroker, real estate broker, or whatever, owes a duty to his client not to take advantage of him and make secret profits, or to sell him down the river by not getting a proper and fair price for him.

Now, that still does not determine whether there has been a contract here, or whether he has breached his duty.

It says: "If you do, you are in trouble," and that's what it says, but it still does not answer my question, and you have no testimony that this particular stock was traded over the counter, and that's all.

MR. FIELDS: May I be heard?

THE COURT: Just very quickly.

MR. FIELDS: I represent to the Court that this section I just read to you applies to all transactions of any kind, whatsoever.

THE COURT: Well, I represent to you that it has no meaning, other than what I have said, and apparently you can't get it through your head as to what I have told you, so [Page 143] let's go out in to open court.

It's a very limited meaning, and you have misconstrued, and misunderstood that.

I'm sorry, but it has no such meaning, as you give it, and apparently you haven't been listening to what I said.

Now, let's go out, and we are going to go ahead and move this along in a proper manner.

(Thereupon, Court and counsel proceeded to open court and the following proceedings were had in open court in the presence of the jury.)

THE COURT: Mr. Gilgoff, could you possible read back the last question.

(Previous question read by the reporter.)

THE COURT: I sustained the objection on the grounds that there is no such evidence, and I have made my ruling in chambers for the reasons I have given, as stated before; that this assumes a lot of things and it is not proper, so I have sustained the objection to that.

MR. FIELDS: Q Mr. Newman, at the time that you first started dealing in a business sense with Mr. Talbot, did you have other brokers in Santa Rosa?

A Yes, sir.

Q And who were they?

A I dealt with Dean Whitter, and I believe at the time the broker's name was "Clemen Nock." He's now with First California—or was—and Robert Douglas, and before then I dealt with Burr Wilson and Company, and before then I dealt with Reynolds and Company.

INSTRUCTION NO. .....

REQUESTED BY DEFENDANTS

SUBJECT:

In exercising its duty of fair dealing, a broker must determine that the price of a security is fair.

In the Matter of Samuel B. Franklin & Co., (1959) 38 S.E.C. 908, '57-'61 CCH Dec. ¶ 76, 647.

In the Matter of Graham and Company, (1958) 38 S.E.C. 314, '57-'61 CCH Dec. ¶ 76, 581

GIVEN:
REFUSED:
GIVEN AS MODIFIED:

.....

Judge

INSTRUCTION NO. .....

REQUESTED BY DEFENDANTS

SUBJECT:

In exercising its duty of fair dealing, a broker must determine that the price of a security is fair and is reasonably related to current market prices.

In the Matter of Samuel B. Franklin & Co., (1959) 38 S.E.C. 908, '57-'61 CCH Dec. ¶ 76, 647.

In the Matter of Graham and Company, (1958) 38 S.E.C. 314, '57-'61 CCH Dec. ¶ 76, 581

GIVEN:
REFUSED:
GIVEN AS MODIFIED:

.....

Judge

INSTRUCTION NO. .....

REQUESTED BY DEFENDANTS

SUBJECT:

When dealing as a broker or agent for two parties to the same transaction, a securities dealer owes a duty of fair dealing with full disclosure of his dual capacity to both parties to the transaction.

NASD, Rules of Fair Practise, Article III, Section, 1 and 12.

GIVEN:
REFUSED:
GIVEN AS MODIFIED:

.....

Judge

INSTRUCTION NO. .....

REQUESTED BY DEFENDANTS

SUBJECT:

A dealer in securities has a duty to observe high standards of commercial honor and just and equitable principles of fair trade in his dealings with and for his customers and clients.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, Rules of Fair Practise, Article III, Section 1.

GIVEN:
REFUSED:
GIVEN AS MODIFIED:

.....

Judge

INSTRUCTION NO. .....

REQUESTED BY DEFENDANTS

SUBJECT:

If you find that plaintiff knew that First California Company was subject to certain regulatory associations or agencies, then you are instructed that plaintiff is bound by the rules and regulations of such regulatory associations or agencies regardless of whether he was fully informed concerning them.

White v. Merrill, Lynch, etc., 218 A2d 655 (1966).

GIVEN:
REFUSED:
GIVEN AS MODIFIED:

.....

Judge